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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1985

RICHARD D. BENNETT and CAROLE A. BENNETT,
Petitioners

v.

UNITED STATES TRUST COMPANY OF NEW YORK,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

(1) Whether the defendant in an action brought under the Racketeer Influenced and Corrupt Organizations Act, can be both the "person" and the "enterprise" within the meaning of that Act?

(2) Whether a bank's knowing misrepresentation that certain stocks pledged to the bank as collateral for a loan were not subject to the margin rules was made "in connection with" the purchase or sale of securities within the meaning of §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder?

(3) Whether there is a private right of action for violation of the margin rules promulgated pursuant to §7 of the Securities Exchange Act of 1934?

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RICHARD D. BENNETT and CAROLE A. BENNETT,
Petitioners

v.

UNITED STATES TRUST COMPANY OF NEW YORK,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Richard D. Bennett and Carole A. Bennett petition this Court for a writ of certiorari to the United States Court of Appeals for the Second Circuit.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 770 F.2d 308 and is reprinted in Appendix A. The District Court's unreported memorandum and order of November 27, 1984 dismissing petitioners' complaint for failure to state a claim upon which relief could be granted is reprinted in Appendix B.

JURISDICTION

The judgment of the Court of Appeals affirming the District Court was entered August 9, 1985. This petition for a writ of certiorari was filed within 90 days of that date. This Court has jurisdiction to review the decision of the Court of Appeals pursuant to 28 U.S.C. §1254(1).

STATUTORY PROVISIONS, RULES AND REGULATIONS INVOLVED

The following statutes, rules and regulations are involved in this case:

(1) The Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §1962(c);

(2) Section 7 of the Securities Exchange Act of 1934, 15 U.S.C. §78(g);

(3) Federal Reserve Regulation U promulgated pursuant to Section 7 of the Securities Exchange Act of 1934, 12 C.F.R. §221.1(a)(1);

(4) Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78(j)(b);

(5) Rule 10b-5 promulgated pursuant to Section 10(b) of the Securities Exchange Act of 1934, 17 C.F.R. §240.10b-5.

The texts of these statutory provisions, rules and regulations are reprinted in Appendix C.

STATEMENT OF THE CASE

Petitioners (the "Bennetts") were the recipients of five loans made over a two-year period totalling $4,675,000. These loans were made by the respondent ("U.S. Trust") in order to enable the Bennetts to purchase certain securities which were to be deposited with U.S. Trust as collateral for the loans. The loans were in

excess and in violation of the limits provided for in the applicable margin rules.

At the time these loans were made, the Bennetts allege that U.S. Trust, knowing that the loan proceeds were to be used to purchase securities and that the securities were to be deposited with the bank as collateral, knowingly and recklessly told the Bennetts that the margin rules did not apply to the particular type of securities — public utility stocks — that the Bennetts were to purchase with the loans. In fact, the margin rules did apply and the Bennetts incurred losses on the stocks which were substantially greater than the losses which they would have incurred if U.S. Trust had not extended such excessive and unlawful credit.

The Bennetts thus brought this suit in the Southern District of New York, alleging that U.S. Trust made misrepresentations which were, in violation, *inter alia*, of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§1961 et seq., ("RICO"); §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78(j)(b), and Rule 10b-5 thereunder, 17 C.F.R. §240.10b-5; and §7 of the Securities Exchange Act of 1934, 15 U.S.C. §78g, and regulations promulgated pursuant thereto. Jurisdiction was invoked pursuant to §27 of the Securities Exchange Act of 1934 (15 U.S.C. §78aa); 28 U.S.C. §1331; 28 U.S.C. §1332; and principles of pendent jurisdiction. The Bennetts sought damages based on the decline in market value of the stocks purchased with the loan proceeds relative to the outstanding principal and interest on the loans.

U.S. Trust moved to dismiss under Fed. R. Civ. P. 12(b)(6), for failure to state a claim upon which relief could be granted. The motion was granted. The District Court held that no private right of action exists under §7 of the Securities Exchange Act of 1934 and that the remaining claims failed to state a cause of action because

there was an insufficient causal connection between U.S. Trust's misrepresentations and the Bennetts' losses. *See* Appendix B.

On appeal, the United States Court of Appeals for the Second Circuit affirmed. The Second Circuit held that no private right of action exists under §7 of the Securities Exchange Act of 1934. *See* p.A-6 of Appendix A. It also held that the Bennetts' losses and the alleged misrepresentations were not sufficiently related to establish the "loss causation" required to support a claim under §10(b) of the Securities Exchange Act of 1934, or Rule 10b-5 thereunder. *See* pp. A-10 and A-11 of Appendix A. And with respect to the Bennetts' cause of action under RICO, the Second Circuit held that the allegations of the complaint were deficient because the Bennetts characterized U.S. Trust both as the "enterprise" and the "person" under RICO, and the Second Circuit said that to state a cause of action under RICO the "enterprise" and the "person" as defined by that statute must be separate entities. *See* p. A-13 of Appendix A.

REASONS FOR GRANTING THE WRIT

I.

THE DECISION BELOW CONFLICTS WITH THE DECISION OF ANOTHER COURT OF APPEALS AS TO THE PROPER INTERPRETATION OF §1962(c) OF RICO.

This Court recently issued its first opinion dealing with the proper construction to be given to the Racketeer Influenced and Corrupt Organizations Act ("RICO"), in civil cases. *Sedima, S.P.R.L. v. Imrex Company*, _____U.S. _____, 105 S. Ct. 3275 (1985). In *Sedima*, this Court, in reversing the Second Circuit, held that RICO does not require either (i) a prior criminal conviction, or (ii) a special "racketeering injury" beyond injury caused by the predicate acts. In its opinion, this Court

mandated that RICO was to be interpreted broadly in order to effectuate RICO's remedial purposes. _____U.S. at _____, 105 S. Ct. at 3286.

In the wake of that mandate, the Second Circuit in this case has once again interpreted RICO narrowly, by holding that under §1962(c) of Title 18, the "person" and the "enterprise" cannot be the same entity. This holding, apart from being erroneous and in derogation of this Court's command that RICO be read broadly, is in direct conflict with the holding of the Eleventh Circuit and presents an important issue of federal law which should be settled by this Court.

Section 1962(c) of Title 18 provides:

> It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

In reliance upon what it said was the "plain language" of this statute and the legislative intent, the Second Circuit in this case held that the "person" and the "enterprise" set forth in §1962(c) must be different entities. *See* pp. A-12 and A-13 of Appendix A. The Court reasoned that the statute distinguishes between the "person" and the "enterprise" to insure that the focus is on the culpable person and not on an enterprise which "is often a passive instrument or victim of the racketeering activity." *See* p. A-13 of Appendix A.

In its opinion, the Second Circuit conceded that its interpretation of §1962(c) conflicts with that adopted by the Eleventh Circuit in *United States v. Hartley*, 678 F.2d 961, 987-90 (1982), cert. denied, 459 U.S. 1170 (1983). *See* p. A-12 of Appendix A. However, the Second Circuit did not bother to distinguish *United States v. Hartley* or to point out why it thought the reasoning in

United States v. Hartley was unsound. It merely stated that it was adopting the view taken by certain other Courts of Appeals that have addressed this issue. *See* p. A-13 of Appendix A.

Despite the Second Circuit's failure fully to address the conflict, a comparison of its decision with the Eleventh Circuit's decision in *United States v. Hartley* indicates that a genuine and fundamental conflict exists between the circuits. This is because both the Eleventh Circuit and the Second Circuit purported to rely on the "plain meaning" of the statute and the intent of Congress, but nevertheless reached opposite results.

For its "plain meaning" rationale, the Eleventh Circuit turned to the definitional section of RICO. Section 1961(4) of Title 18 defines an "enterprise" to include "any individual, partnership, corporation, association, or other legal entity, and any union or group of individuals associated in fact, although not a legal entity." 18 U.S.C. §1961(4). Section 1961(3) of Title 18 defines a "person" as "any individual or entity capable of holding a legal or beneficial interest in property." 18 U.S.C. §1961(3). Based on these definitions, the Eleventh Circuit concluded that it was clear that Congress contemplated it was possible for the "person" and the "enterprise" to be the same entity. 678 F.2d at 988.

For its "legislative intent" rationale, the Eleventh Circuit noted that as a matter of statutory interpretation, RICO was to be given as broad a reading as possible to effectuate its remedial purposes. *Id.* at 988. Using this guiding principle, which this Court approved in *Sedima*, the Eleventh Circuit held that the "person" and "enterprise" could be the same entity.

In contrast, the Second Circuit did not expound upon its "plain meaning" rationale at all, but rather indicated that the "enterprise" is often a passive and innocent victim and the "person" is usually the culpable party and that RICO should not be used to reach innocent "enterprises." *See* p. A-13 of Appendix A. However,

in making that observation, the Second Circuit failed to address the exception to that observation which was contained in the very facts it had before it — that is, the "enterprise" which is not a passive and innocent victim but is itself the culpable party.

The Second Circuit is therefore in conflict with the Eleventh Circuit and has ignored this Court's direction in *Sedima* that RICO is to be construed liberally. It has also adopted a poorly reasoned rationale which allows culpable enterprises to escape liability. In addition, because the Second Circuit's holding can be escaped by simply drafting a complaint which names as the "enterprise" both the company and at least one employee of that company, it serves no real purpose.

This Court should grant certiorari to resolve this conflict between the circuits and to address these issues because they are necessary to a proper interpretation of RICO.

II.

THE DECISION BELOW CONFLICTS WITH THE DECISION OF ANOTHER COURT OF APPEALS AS TO THE REQUIREMENT OF CAUSATION UNDER §10(b) AND RULE 10b-5.

The Second Circuit's decision in this case also creates a conflict with a decision from another Circuit on a recurring issue of substantial importance in the administration of the securities laws — namely, causation under §10(b) of the Securities Exchange Act of 1934.

Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78(j)(b)), and Rule 10b-5 thereunder (17 C.F.R. §240.10b-5), provide that it is unlawful for any person to make any misrepresentation "in connection with" the purchase or sale of any security.

The Second Circuit in this case was asked to decide whether a specific misrepresentation — that the margin

rules were inapplicable to public utility stocks pledged as collateral to a bank — met the "in connection with" requirement and adequately alleged an injury caused by the misrepresentation. The Second Circuit found that it did not because the misrepresentation related to whether the margin rules applied to the specific type of securities and not to the value of the securities themselves *See* pp. A-10 and A-11 of Appendix A. In other words, the Second Circuit held that the "in connection with" requirement and the causation test meant that the misrepresentation had to relate directly to the investment value of the securities.

This reading of the "in connection with" and the causation requirements ignores the fact that there are many kinds of misrepresentations made in connection with the purchase and sale of securities which do not necessarily relate to the investment value of the securities that §10(b) and Rule 10b-5 were nevertheless intended to reach. Many types of fraud, such as churning, which do not relate to the investment value of the securities, would arguably be permitted by the Second Circuit's decision. Such frauds need to be deterred, but the Second Circuit's decision fails to accomplish that goal.

This fact was recognized by the Third Circuit in *Angelastro v. Prudential-Bache Securities, Inc.*, 764 F.2d 939 (3rd Cir. 1985), *cert. denied*, 54 U.S.L.W. 3271 (Oct. 22, 1985) (No. 85-421). That Court refused to give §10(b) and Rule 10b-5 such a narrow interpretation as the one adopted by the Second Circuit in this case.

In *Angelastro*, the plaintiff alleged misrepresentations and non-disclosures regarding the credit terms of a margin account. The District Court dismissed the Rule 10b-5 claim on the ground that "there are no allegations that the defendants made any misrepresentations about any particular securities." 575 F. Supp. 270, 273-74 (D.N.J. 1983). That Court therefore concluded that the

complaint did not meet Rule 10b-5's "in connection with" or causation tests.

On appeal, the Third Circuit reversed. It stated that while "concealment or misrepresentation of interest terms relating to a margin account does not affect the investment value of a particular security", nevertheless it affects "the course of dealing in securities" and so has a sufficient relationship with a purchase or sale to meet the "in connection with" and causation tests. 764 F.2d at 943.

The *Angelastro* case is almost identical to this case. The holding of the Third Circuit, that a misrepresentation regarding the credit terms of a margin account violates Rule 10b-5, is in direct conflict with the Second Circuit's holding in this case that a misrepresentation regarding the applicability of the margin rules to certain stocks does not violate Rule 10b-5. This conflict should be resolved by this Court because it affects the administration of the anti-fraud provisions of the federal securities laws.

III.

THE DECISION BELOW RAISES IMPORTANT AND RECURRING ISSUES CONCERNING THE ENFORCEMENT OF THE MARGIN RULES.

This Court has never decided whether there is an implied private right of action against a lender who violates the margin rules. The resolution of that question by this Court is important because the Second Circuit and other circuits which have recently considered this issue are in error and are in effect foreclosing the possibility that this issue will be litigated before this Court in the future unless this Court reviews this question now. In addition, the courts that are rejecting the existence of a private right of action under the margin rules are in effect allowing the margin rules to be entirely unenforced.

Section 7 of the Securities Exchange Act of 1934, 15 U.S.C. §78(g), and the regulations promulgated thereunder, make unlawful the extension of excessive margin credit in securities transactions. *See* Federal Reserve Regulation U, 12 C.F.R. §221.1 (a) (1) (1983), reprinted at p. A-25 of Appendix C. In this case the Bennetts allege — and U.S. Trust does not deny — that they were extended credit in violation of the margin rules.

The question presented in this case is whether there is an implied private right of action for violation of the margin rules on the part of an innocent, good faith investor against a willful or reckless lender. The Second Circuit decided there is not, even if the plaintiff was innocent and the defendant knowingly and recklessly misrepresented the applicability of the margin rules. We submit this was erroneous.

A private remedy for innocent, good faith borrowers against willful lenders is consistent with §7's statutory scheme. The legislative history indicates that §7 was passed to protect private investors. *See Palmer v. Thomson & McKinnon Auchincloss, Inc.*, 427 F. Supp. 915, 921 (D. Conn. 1977); *Panayotopulas v. Chemical Bank*, 464 F. Supp. 199, 202 (S.D.N.Y. 1979); *Stern v. Merrill Lynch, Piece, Fenner & Smith, Inc.*, 603 F.2d 1073, 1097-99 (4th Cir. 1979) (dissenting opinion, and materials therein cited). *See also* Board of Governors, Federal Reserve System, *A Review and Evaluation of Federal Margin Regulations* (1984), at 3, 114, 126. If this objective is to be met, private actions by innocent investors for margin violations must be allowed because they are the only realistic mechanism for deterring lenders from engaging in the sort of margin violations that the Bennetts allege U.S. Trust engaged in in this case.

Several authorities have noted that when an innocent investor who accepts credit extended in violation of the margin rules is not allowed a private right of action, the margin rules as a practical matter will be almost totally unenforced. *See Palmer, supra*, 427 F. Supp. at 921.

See also Silbaugh, *Regulation X: A Complexis*, 50 Notre Dame Lawyer 136 (1975), which discusses the panoply of possible sanctions against a lender for violation of §7 and the reasons why those sanctions are almost never likely to be employed against U.S. Trust or any other lender who violates the margin rules, unless a private right of action for violation of the margin rules is allowed. If this case is any example, here there were substantial margin violations from 1977 through 1981 by U.S. Trust, yet we are aware of no enforcement action taken by any agency for those violations. A private suit by the Bennetts is the only means by which those violations can be rectified and future violations can be deterred.

This issue presents an important question regarding the margin rules which should be addressed by this Court, because without a private right of action for violation of the margin rules, the margin rules will in fact be unenforced.

CONCLUSION

For the reasons stated, this Court should grant the petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit.

Respectfully Submitted,

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November 6, 1985

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 948 August Term, 1984

(Argued March 20, 1985 Decided August 9, 1985)

Docket No. 84-9036

RICHARD D. BENNETT and CAROLE A. BENNETT,

Plaintiffs-Appellants,

v.

UNITED STATES TRUST COMPANY OF NEW YORK,

Defendant-Appellee.

B e f o r e: MESKILL and PRATT, *Circuit Judges*, and PALMIERI,* *District Judge*

Appeal from a final judgment entered in the United States District Court for the Southern District of New York, Duffy, *J.*, dismissing appellants' complaint pursuant to Fed. R. Civ. P. 12(b)(6).

Affirmed.

MESKILL, *Circuit Judge*:

This is an appeal from a final judgment of the United States District Court for the Southern District of New York, Duffy, *J.*, dismissing appellants' complaint for failure to state a claim upon which relief could be granted. The complaint alleges causes of action under section 7 of the Securities Exchange Act of 1934, 15 U.S.C. §78g (1982), under section 10(b) of the 1934 Act, 15 U.S.C. §78(j)(b) (1982), and rule 10b-5, 17 C.F.R. §240.10b-5

* Honorable Edmund L. Palmieri, United States District Judge for the Southern District of New York, sitting by designation.

(1984), under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§1961 *et seq.* (1982) (RICO), under N.Y. Gen. Bus. Law §§352-359g (part of the "Martin Act") and under the common law. The district court granted appellee's Fed. R. Civ. P. 12(b)(6) motion, ruling that no private cause of action exists under section 7 and that there was an insufficient causal connection between appellee's acts and appellants' loss for the remaining claims to state a cause of action. For the reasons that follow we affirm.

BACKGROUND

This action arises out of a series of loans made between 1977 and 1981 by appellee United States Trust Company of New York (U.S. Trust) to appellants Richard D. and Carole A. Bennett (the Bennetts). The Bennetts used the loan proceeds to purchase public utility stock, depositing the stock with U.S. Trust as collateral. According to the complaint, in making these loans U.S. Trust knowingly or recklessly misrepresented to the Bennetts that the Federal Reserve's margin rules do not apply to public utility stock deposited with a bank as collateral. As a net result of these loans, even though the Bennetts had deposited $1 million in unencumbered public utility stock with U.S. Trust, their account was undermargined.

Eventually, the dividends generated by the public utility stock proved insufficient to cover the interest expenses on the loans, causing the outstanding principal and interest to increase. Concurrently, the market value of the stock decreased and in late 1981 U.S. Trust liquidated the Bennetts' account. At the time of liquidation, the outstanding principal and interest exceeded the stock's market value by $1.2 million. Thus, in addition to the loss of their $1 million in equity, the Bennetts owed U.S. Trust $1.2 million.

The Bennetts commenced this action in April 1984 seeking damages based on the decline in market value of the stock purchased with the loan proceeds and on the interest charged on the loans. The complaint alleges eight causes of action: the first two seek recovery under section 7 and the margin rules, the third seeks recovery for breach of representation, the fourth seeks recovery under section 10(b) and rule 10b-5; the fifth seeks recovery for common law fraud; the sixth seeks recovery under the Martin Act and the seventh and eighth seek recovery under RICO.

U.S. Trust moved to dismiss the complaint pursuant to Fed. R. Civ. P. 12(b)(6) for failure to state a claim upon which relief could be granted. By Memorandum and Order dated November 26, 1984, the district court granted the motion. It dismissed the two claims brought under the margin rules because it determined that Congress did not intend to create a private cause of action under section 7. It dismissed the remaining claims because it believed that there was an inadequate causal relationship between U.S. Trust's acts and the Bennetts' losses.

DISCUSSION

The Bennetts appeal the entire ruling made below, asserting that all eight causes of action state grounds for relief. We affirm the judgment of the district court.

I. *Federal Claims*

A. *Section 7*

The Bennetts' first two causes of action seek recovery based on U.S. Trust's violation of Regulation U. Regulation U was promulgated by the Federal Reserve pursuant to section 7 of the Securities Exchange Act of 1934, 15 U.S.C. §78g (1982). Section 221.1(a)(1) of Regulation U, as it existed at the time of the loans, provided, in pertinent part:

> [N]o bank shall extend any credit secured directly or indirectly by any margin stock for the purpose of purchasing or carrying any margin stock in an amount exceeding the maximum loan value of the collateral, as prescribed from time to time.

12 C.F.R. §221.1(a)(1) (1983). According to the Bennetts, an innocent, good faith investor has a private right of action against a bank that violates Regulation U.

Neither section 7 nor Regulation U expressly provide for a private cause of action. Nevertheless, in *Pearlstein* v. *Scudder & German*, 429 F.2d 1136 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013, 91 S.Ct. 1250, 28 L.Ed.2d 550 (1971) (*Pearlstein I*), a divided panel of this Court held that a private cause of action exists for violations of section 7. Since our decision in *Pearlstein I*, however, there have been two developments that directly affect this issue. First, section 7 was amended and a new subsection f was added. Pub. L. No. 91-508, Title III, §301(a), 84 Stat. 1114, 1124 (1970) (codified at 15 U.S.C. §78g(f) (1982)). Prior to the enactment of subsection f it was only unlawful to extend credit in violation of the margin rules. Subsection f makes it also unlawful to accept credit in violation of those rules. We have previously recognized that the addition of subsection f "cast[s] doubt on the continued viability of the rationale" of *Pearlstein I*. *Pearlstein* v. *Scudder & German*, 527 F.2d 1141, 1145 n.3 (2d Cir. 1975) (*Pearlstein II*).

Second, in the years since *Pearlstein I* was decided, the Supreme Court has altered its method of analyzing claims of implied causes of action. In *Cort* v. *Ash*, 422 U.S. 66, 95 S.Ct. 2080, 45 L.Ed. 2d 26 (1975), the Court listed four criteria that should be considered when determining if an implied cause of action exists: (1) whether "the plaintiff [is] 'one of the class for whose *especial* benefit the statute was enacted,'" (2) whether there is "any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one,"

(3) whether it is "consistent with the underlying purposes of the legislative scheme to imply such a remedy," and (4) whether "the cause of action [is] one traditionally relegated to state law . . . so that it would be inappropriate to infer a cause of action based solely on federal law." 422 U.S. at 78, 95 S.Ct. at 2088 (quoting *Texas & Pacific Ry. Co.* v. *Rigsby*, 241 U.S. 33, 39, 36 S.Ct. 482, 484, 60 L.Ed 874 (1916)). Although early post-*Cort* decisions treated each of these four factors as independent tests, subsequent Supreme Court decisions have indicated that they should not be so treated. Thus, while these factors remain relevant, the central inquiry must be whether Congress intended to create a private cause of action. *See, e.g., Daily Income Fund* v. *Fox*, ___U.S. ___, ___, 104 S.Ct. 831, 838, 78 L.Ed.2d 645 (1984); *Merrill Lynch, Pierce, Fenner & Smith* v. *Curran*, 456 U.S. 353, 377-78, 102 S.Ct. 1825, 1838-39, 72 L.Ed.2d 182 (1982); *see also Schrachta* v. *Curtis*, 752 F.2d 1257, 1258-59 (7th Cir. 1985).

In the wake of these two developments, district courts in this Circuit are split over whether *Pearlstein I* remains good law. *Compare Panayotopulas* v. *Chemical Bank*, 464 F.Supp. 199, 201-03 (S.D.N.Y. 1979) (private cause of action exists under section 7 for bank's violation of Regulation U); *Palmer* v. *Thomson & McKinnon Auchincloss, Inc.*, 427 F.Supp. 915, 919-22 (D. Conn. 1977) (private cause of action exists under section 7 for broker's violation of Regulation T), *with Schy* v. *FDIC*, 465 F.Supp. 766, 770-75 (E.D.N.Y. 1977) (no private cause of action exists under section 7 for bank's violation of Regulation U); *Establissement Tomis* v. *Shearson Hayden Stone, Inc.*, 459 F.Supp. 1355, 1358-60 (S.D.N.Y. 1978) (no private cause of action exists under section 7 for broker's violation of Regulation T).

There is no conflict, however, among the circuit courts that have recently considered this issue. All five that have decided the question have held that no private cause of action exists under section 7. *Bassler* v. *Central*

National Bank, 715 F.2d 308, 310-13 (7th Cir. 1983); *Walck* v. *American Stock Exchange*, 687 F.2d 778, 788-89 (3d Cir. 1982), *cert. denied*, 461 U.S. 942, 103 S.Ct. 2118, 77 L.Ed. 2d 1300 (1983); *Gilman* v. *FDIC*, 660 F.2d 688, 691-93 (6th Cir. 1981); *Gutter* v. *Merrill Lynch, Pierce, Fenner & Smith*, 644 F.2d 1194, 1197-99 (6th Cir. 1981), *cert. denied*, 455 U.S. 909, 102 S.Ct. 1256, 71 L.Ed.2d 447 (1982); *Stern* v. *Merrill Lynch, Pierce, Fenner & Smith*, 603 F.2d 1073, 1074-93 (4th Cir. 1979); *Utah State University* v. *Bear, Stearns & Co.*, 549 F.2d 164, 169-70 (10th Cir.), *cert. denied*, 434 U.S. 890, 98 S.Ct. 264, 54 L.Ed.2d 176 (1977).

We agree and hold that no private right of action exists under section 7. First, as the above decisions recognize, there is simply no evidence that in passing section 7 Congress intended to create a private cause of action. *Bassler*, 715 F.2d at 313 ("there is no indication of legislative intent, explicit or implicit, to create a private right of action"); *Walck*, 687 F.2d at 789 (there is "no significant evidence of congressional intent to imply a remedy in § 7;" presence of express remedies in other sections of 1934 Act raises inference that absence of express remedy under section 7 was purposeful); *Gilman*, 660 F.2d at 692 ("The language and legislative history of section 7 convince us that Congress did *not* intend to create a remedy in favor of borrowers."); *Gutter*, 644 F.2d at 1199 ("there is no indication of Congressional intent to create a [private] cause of action . . ., and the enactment of Section 7(f) indicates a contrary intent"); *Stern*, 603 F.2d at 1092 ("it is not to be assumed that a statute which extends its prohibition to an investor, as this statute does as a result of Section 7(f), was intended to provide that investor with a private right of action for violation of the statute"). The absence of any indication of legislative intent to create a private cause of action under section 7 strongly suggests that Congress did not intend to create one.

Second, section 7 was clearly not passed for the "especial benefit" of individual investors. The major reason for enacting section 7 was to control the excessive use of credit in security transactions. Indeed, even the *Pearlstein I* Court recognized "that the protection of individual investors was a purpose only incidental to the protection of the overall economy from excessive speculation." 429 F.2d at 1140. While this fact standing alone would not justify a conclusion that there is no private cause of action under section 7, when coupled with the absence of any indication of legislative intent to the contrary, it certainly supports such a conclusion.

Finally, it is doubtful that allowing a private cause of action would be consistent with the "underlying purposes of the legislative scheme." As stated above, the underlying purpose of section 7 is to regulate the use of credit in securities transactions. As the addition in section 7(f) makes clear, this regulation is aimed at both lenders and investors. While allowing a private cause of action could conceivably deter violations by lenders, it seems just as conceivable that it could encourage violations by investors seeking to shift the risk of loss. *See, e.g., Stern*, 603 F.2d at 1092-93; *Utah State*, 549 F.2d at 170; *Establissement Tomis*, 459 F.Supp. at 1360; *see also Pearlstein I*, 429 F.2d at 1148 (Friendly, *J.*, dissenting). Again, while this fact is not determinative, it supports the conclusion that Congress did not intend to create a private cause of action under section 7.

Recognizing the lack of express congressional intent to create a broad private cause of action under section 7, the Bennetts argue that a private cause of action should be inferred in those situations where the lender is culpable and the investor has acted in good faith. This argument, which is premised on the Federal Reserve's promulgation of 12 C.F.R. § 224 (1985) exempting good faith investors from criminal liability under section 7(f), has been rejected by several courts, *see, e.g., Bassler*, 715 F.2d at 311; *Stern* 603 F.2d at 1083-84; *Utah State*, 549

F.2d at 170. We agree with their holdings. The Federal Reserve's decision to exempt good faith investors from sanctions for margin violations does not provide a basis for concluding that in enacting section 7 Congress intended to create a private cause of action in their favor.

In sum, the addition of section 7(f) and the Supreme Court's modification of its method of analyzing claims of implied causes of action require a reexamination of our *Pearlstein I* holding. Upon such a reexamination, we agree with the unanimous view of the circuit courts that have subsequently considered the issue and hold that there is no implied cause of action for violations of section 7. Therefore, the district court properly dismissed the Bennetts' first two causes of action.

B. *Section 10(b) and Rule 10b-5*

The Bennetts also brought a claim under section 10(b) and rule 10b-5. They allege that U.S. Trust misrepresented that the margin rules do not apply to public utility stocks held by a bank as collateral, that this misrepresentation was made in connection with the purchase of securities and that it caused them damage. The district court dismissed this cause of action, concluding that there was no causal connection between the misrepresentation and the loss. The court stated:

> Plaintiffs' losses resulted solely from their own trading activities in the stock market. Indeed, if they had invested the funds more wisely, they could actually have increased their equity. Clearly, then, they cannot now claim that defendant's alleged fraud caused their losses. Rather, it was the Bennetts' own unwise investment choices which brought about their losses.

Bennett v. *United States Trust Co.*, No. 84 Civ. 3038, Memorandum and Order at 6 (S.D.N.Y. Nov. 26, 1984), *reprinted in* J. App. at 26, 31.

In order to recover under section 10(b), a plaintiff must establish that the misrepresentation complained of caused the injury suffered. To establish causation, the plaintiff must show "both *loss causation* — that the misrepresentations or omissions caused the economic harm — and *transaction causation* — that the violations in question caused the [plaintiff] to engage in the transaction in question." *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied*, 421 U.S. 976, 95 S.Ct. 1976, 44 L.Ed.2d 467 (1975). We agree with the district court's conclusion that the Bennetts have failed to allege the requisite causation.

The Bennetts went to U.S. Trust with the idea of borrowing money to purchase public utility stock already in mind. U.S. Trust told the Bennetts that the margin rules do not apply to public utility stock pledged to a bank as collateral. The loans were then made and the public utility stock was bought. There are no allegations that U.S. Trust recommended that the Bennetts purchase public utility stock in general, that U.S. Trust recommended any particular public utility stock or that U.S. Trust misrepresented the investment value of any public utility stock. The Bennetts, and the Bennetts alone, decided to invest in public utility stock.

The Bennetts argue, however, that if U.S. Trust had refused to make the loans, they would not have been able to purchase the stock. Thus, they claim that U.S. Trust caused the loss in question. This argument fails to distinguish between transaction causation and loss causation. The Bennetts' but-for allegations at most establish transaction causation. *Chemical Bank* v. *Arthur Andersen & Co.*, 726 F.2d 930, 943 & n.23 (2d Cir.), *cert. denied*, ____U.S. ____, 105 S.Ct. 253, 83 L.Ed.2d 190 (1984). They fail to establish the necessary loss causation; there is simply no direct or proximate relationship between the loss and the misrepresentation. *See Bloor* v. *Carro, Spanbock, Londin, Rodman & Fass*, 754 F.2d 57, 61-62 (2d Cir. 1985).

The Bennetts rely heavily on our decision in *Marbury Management, Inc.*, v. *Kohn*, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011, 101 S.Ct. 566, 66 L.Ed.2d 469 (1980), to support their argument that their allegations of causation are adequate. However, we believe that *Marbury* is clearly distinguishable from the case before us. In *Marbury*, a trainee at a brokerage firm misrepresented his expertise by claiming that he was a stockbroker and a "portfolio management specialist." That misrepresentation, unlike the misrepresentation in this case, induced plaintiffs to purchase and retain specific securites despite their misgivings about the stock. Moreover, although the misrepresentation was not related to the intrinsic investment characteristics of the stock involved, it did directly relate to the investment quality of the stock because had the plaintiffs known that their "broker" was a trainee who had no expertise, they would not have accepted his recommendations. In essence, the stock in question did not have the value represented by the "broker." Thus, because the misrepresentation in *Marbury* both induced the purchase and related to the stock's value, it could be deemed causally related to the loss. In the instant case, however, the misrepresentation neither induced the purchase nor related to the stock's value.

In sum, even if the Bennetts' purchase of public utility stock and U.S. Trust's misrepresentation are sufficiently related to establish transaction causation, the Bennetts' loss and the misrepresentations are clearly not sufficiently related to establish loss causation. The loss at issue was caused by the Bennetts' own unwise investment decisions, not by U.S. Trust's misrepresentation.[1]

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1. The Bennetts also argue that even if we hold that the misrepresentation did not cause the loss resulting from the decline in the stock's value, they should still be entitled to recover the loss resulting from the interest charges. We find this argument unconvincing. U.S. Trust is not alleged to have made any misrepresentation with respect to the loans; the Bennetts received the

In the absence of an adequate allegation of causation, the district court's dismissal of the section 10(b) claim was proper.

C. *RICO*

In their seventh and eighth causes of action, the Bennetts seek treble damages and attorneys' fees under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961 *et seq.* (1982). The seventh cause of action is predicated on the alleged section 10(b) and rule 10b-5 violations; the eighth cause of action is predicated on an alleged mail fraud, 18 U.S.C. §1341 (1982).

Although the Bennetts' two RICO claims do not specify the section under which they are brought, it is clear from the language of the complaint that section 1962(c) is the only relevent one. Section 1962(c) provides:

> It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

U.S. Trust argues that the complaint is deficient because it apparently casts U.S. Trust as both the "enterprise" and the "person."[2] *See, e.g., B.F. Hirsch* v. *Enright Re-*

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money that they sought, for the purpose desired, and under conditions that they understood and found agreeable. The interest expense would have been the same no matter how the Bennetts used the loan proceeds. Thus, we cannot accept the complaint's characterization of the interest expense as an element of damages.

2. The complaint does not name the "person" who conducted the affairs of U.S. Trust in the proscribed manner. However, because U.S. Trust is named as the defendant, we interpret the complaint to name U.S. Trust as the section 1962(c) "person." Thus, U.S. Trust is named as both the "person" and the "enterprise."

fining Co., 751 F.2d 628, 634 (3d Cir. 1984) ("a violation of section 1962(c) by a corporate entity requires an association with an enterprise that is not the same corporation"); *Haroco, Inc.* v. *American National Bank & Trust Co.*, 747 F.2d 384, 400 (7th Cir. 1984) ("section 1962(c) requires separate entities as the liable person and the enterprise"), *aff'd on other grounds*, _____U.S. _____, 105 S.Ct. 3292, 87 L.Ed.2d 361 (1985) (per curiam);[3] *Rea* v. *Union Bank*, 725 F.2d 478, 481 (9th Cir. 1984) ("If Union Bank is the enterprise, it cannot also be the RICO defendant."); *United States* v. *Computer Sciences Corp.*, 689 F.2d 1181, 1190 (4th Cir. 1982) ("'enterprise' was meant to refer to a being different from, not the same as or part of, the person whose behavior the act was designed to prohibit"), *cert. denied*, 459 U.S. 1105, 103 S.Ct. 729, 74 L.Ed.2d 953 (1983); *Bennett* v. *Berg*, 685 F.2d 1053, 1061 (8th Cir. 1982) (defendant may not be both enterprise and person associated with the enterprise), *aff'd in pertinent part in banc*, 710 F.2d 1361 (8th Cir.), *cert. denied*, _____U.S. _____, 104 S.Ct. 527, 78 L.Ed.2d 710 (1983); *Kaufman* v. *Chase Manhattan Bank, N.A.*, 581 F.Supp. 350, 357-58 (S.D.N.Y. 1984) (complaint must distinguish the enterprise from the person); *but see United States* v. *Hartley*, 678 F.2d 961, 988 (11th Cir. 1982), *cert. denied*, 459 U.S. 1170, 103 S.Ct. 815, 74 L.Ed.2d 1014 (1983) ("A corporation may be simultaneously both a defendant and the enterprise under RICO.").

As the above decisions point out, requiring a complaint to distinguish between the enterprise and the person conducting the affairs of that enterprise in the prohibited manner is supported by the plain language of

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3. Nothing in the Supreme Court's recent decisions in *American National Bank & Trust Co.* v. *Haroco, Inc.*, _____ U.S. _____, 105 S.Ct. 3291, 87 L.Ed.2d 437 (1985) (per curiam), and *Sedima S.P.R.L.* v. *Imrex Co.*, _____U.S. _____, 105 S.Ct. 3275, 85 L.Ed.2d _____(1985), indicates that the Court considered this issue.

section 1962(c), which clearly envisions two entities. Moreover, requiring a distinction between the enterprise and the person comports with the legislative intent and policy. Such a distinction focuses the section on the culpable party and recognizes that the enterprise itself is often a passive instrument or victim of the racketeering activity. *See, e.g., B.F. Hirsch*, 751 F.2d at 633-34; *Haroco*, 747 F.2d at 401. Thus, we follow the majority view and hold that under section 1962(c) a corporate entity may not be simultaneously the "enterprise" and the "person" who conducts the affairs of the enterprise through a pattern of racketeering activity. As the Bennetts' complaint places U.S. Trust in both roles, it was properly dismissed.

II. *State Law Claims.*

The Bennetts also assert three state law causes of action: violations of the Martin Act, breach of warranty and common law fraud. This district court found a common flaw in each of these claims, *i.e.*, a lack of causation.

As we concluded when discussing the section 10(b) and rule 10b-5 claims, the Bennetts have at most made out a claim for but-for causation. The Martin Act requires a plaintiff to show "a proximate causal connection between the alleged wrongdoing and the purported damages." *In re Investors Funding Corp. of New York Securities Litigation*, 523 F.Supp. 533, 544 (S.D.N.Y. 1980); *see also Eriksson* v. *Galvin*, 484 F.Supp. 1108, 1128 (S.D.N.Y. 1980); *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath*, 378 F.Supp. 112, 130 (S.D.N.Y. 1974), *modified*, 540 F.2d 27 (2d Cir. 1976). But-for causation alone is inadequate. Thus, the Martin Act claim was properly dismissed.

The absence of adequate causation is also fatal to a common law fraud claim under New York law. *Van Alen* v. *Dominick & Dominick, Inc.*, 441 F.Supp. 389, 403 (S.D.N.Y. 1976), *aff'd*, 560 F.2d 547 (2d Cir. 1977). To

establish the required causation, the plaintiff must show that the loss was a "direct result of the defendant's wrongful actions and [that it was] independent of other causes." *Indress* v. *American University of the Caribbean*, 546 F.Supp. 1342, 1350 (S.D.N.Y. 1982). Again, the Bennetts' but-for allegations are insufficient to state a cause of action.

Finally, the Bennetts seek $2 million in damages under a breach of representation/warranty claim. However, even if U.S. Trust warranted that the margin rules do not apply to public utility stock and breached that warranty, the Bennetts would not be entitled to the damages they seek. Under New York law, breach of warranty damages are usually measured by the benefit of the bargain rule. *Clearview Concrete Products* v. *S. Charles Gherardi, Inc.*, 88 A.D.2d 461, 453 N.Y.S.2d 750, 756 (2d Dep't 1982). "In addition to damages which flow from the loss of the bargain, other damages which are the *natural* and *direct* result of the breach, and which were in the contemplation of the parties," may also be recovered. *Id.* at 469, 453 N.Y.S.2d at 756 (emphasis added). Damages resulting from intervening causes are thus not recoverable. *Id.* The Bennetts do not claim that their loss is recoverable under the benefit of the bargain rule. Neither is it recoverable as damage that is a "natural and direct result of the breach." The loss was directly caused by the public utility stock's poor performance, an event unrelated to the misrepresentation concerning the margin rules. Therefore, this claim was properly dismissed.[4]

The judgment of the district court dismissing the appellants' complaint is affirmed.

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4. The Bennetts did not argue below nor do they argue on appeal that they are entitled to nominal damages on the breach of warranty claim. Therefore, we do not address the issue.

APPENDIX B

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

RICHARD D. BENNETT and CAROLE A. BENNETT, *Plaintiffs*,	:	84 Civ. 3038 (KTD)
v.	:	MEMORANDUM & ORDER
UNITED STATES TRUST COMPANY OF NEW YORK, *Defendant*.	:	

KEVIN THOMAS DUFFY, D.J.:

Plaintiffs Richard D. Bennett and Carole A. Bennett commenced this action against defendant, United States Trust Company of New York ("USTC"), seeking damages allegedly arising out of violations of the Federal Reserve's margin regulations and falsely informing plaintiffs that the loans offered by USTC did not violate the Federal Reserve's margin regulations. Pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, defendant has moved to dismiss plaintiffs' complaint for failure to state a claim upon which relief can be granted. For the reasons set forth below defendant's motion is granted.

FACTS

Plaintiffs maintained an account at USTC totalling approximately $1 million. Beginning in 1977 and continuing through 1982, defendant extended credit to plaintiffs on five separate occasions for the purpose of enabling plaintiffs to purchase and trade securities. Plaintiffs used these borrowed funds to purchase public utility stocks. The dividends on the public utility stocks purchased were insufficient to meet the interest expense

on the loans and, as a result, the size of the outstanding principal and interest on the loans grew. At the same time, the market price of the public utility stocks fell. After eighteen months, the outstanding principal and interest on the loans was more than $1,200,000 greater than the market value of the stocks, and USTC liquidated the accounts. The Bennetts not only lost their $1 million in equity, but now owe the bank more than $1.2 million on the loans.

DISCUSSION

Plaintiffs' first claim for damages arises out of alleged violations by defendant of the margin rules set forth in Regulation U which were promulgated by the Federal Reserve pursuant to section 7 of the Securities Exchange Act of 1934, 15 U.S.C. §78g. Section 221.1(a)(1) of Regulation U, as it existed at the time of the transactions in issue in this case, provided:

> [N]o bank shall extend any credit secured directly or indirectly by any margin stock for the purpose of purchasing or carrying any margin stock in an amount exceeding the maximum loan value of the collateral, as prescribed from time to time. . . .

12 C.F.R. §221.1(a)(1) (1983). Plaintiffs maintain that they have a private right of action under the statute.

In *Cort v. Ash*, 422 U.S. 66 (1975), the Supreme Court set out four factors relevant to determining whether "a private remedy is implicit in a statute." *Id.* at 78. The factors identified in *Cort* include (1) whether the plaintiff is one "for whose especial benefit the statute was enacted;" (2) whether there is any indication of congressional intent to create a private remedy; (3) whether a private remedy is consistent with the legislative scheme; and (4) whether it would be inappropriate to infer a federal cause of action in an area traditionally relegated to state law. *Id.* at 78.

With respect to the first element — whether the plaintiff is the one "for whose especial benefit the statute was enacted" — I have noted previously that "it is patent that a private person is simply not one for whose especial benefit section 7 was enacted." *Nussbacher v. Chase Manhattan Bank, N.A.*, 444 F.Supp. 973, 979 (S.D.N.Y. 1977). "Nor is there any indication of legislative intent to protect individual investors. To the contrary, investor protection is at best an incidental purpose of section 7." *Id.* at 980; *see also Pearlstein v. Scudder & German*, 429 F.2d 1136, 1140 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971). Indeed, it has been held uniformly that "the language and legislative history of section 7 convince us that Congress did *not* intend to create a remedy in favor of borrowers. *Gilman v. Federal Deposit Insurance Co.*, 630 F.2d 688, 692 (6th Cir. 1981) (emphasis in original). To the contrary, "the legislative history reveals a congressional intent to preclude rather than provide a private remedy for individual borrowers." *Id.* at 693 (citing *Gutter v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 644 F.2d 1194, 1199 (6th Cir. 1981); *Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 603 F.2d 1073, 1081-83 (4th Cir. 1979); *Utah State University v. Bear, Stearns & Co.*, 549 F.2d 164, 170 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977)). It is clear, then, that no private right of action exists under section 7 of the Securities Exchange Act of 1934.[1]

Plaintiffs' remaining causes of action include claims arising under (1) section 10(b) of the Securities Exchange Act of 1934 or Rule 10b-5 thereunder; (2) common law fraud; (3) the Martin Act; and (4) the Racketeer Influenced and Corrupt Organizations Act. A common element to all of these claims is the requirement of a causal relationship between defendant's acts and

1. Plaintiffs' argument that innocent, good faith borrowers are treated differently and are entitled to a right of action was expressly rejected in *Bassler v. Central National Bank in Chicago*, 715 F.2d 308, 311 (7th Cir. 1983).

plaintiffs' losses. A mere "but-for" causation test is simply not sufficient. *See Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 943 (2d Cir. 1984) (a " 'but-for' allegation merely establishe[s] 'transaction causation.' . . . [T]hey have failed to establish the 'loss causation' necessary for a legally sufficient claim under §10(b) and Rule 10b-5."); *In re Catanella and E.F. Hutton and Co. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶91,497, No. 546, slip. op. at 31 (E.D. Pa. April 9, 1984) ("transaction causation" insufficient for common law fraud and Section 10(b) and Rule 10b-5 claims); *In re Investors Funding Corp. of New York Securities Litigation*, 523 F. Supp. 533, 544 (S.D.N.Y. 1980) ("a proximate causal connection between the alleged wrongdoing and the purported damages is a necessary element" of a New York Martin Act claim). Plaintiffs' losses resulted solely from their own trading activities in the stock market. Indeed, if they had invested the funds more wisely, they could actually have increased their equity. Clearly, then, they cannot now claim that defendant's alleged fraud caused their losses. Rather, it was the Bennetts' own unwise investment choices which brought about their losses. Accordingly, defendant's motion to dismiss is granted and plaintiffs' complaint is dismissed.

SO ORDERED.

DATED: New York, New York
November 26, 1984

KEVIN THOMAS DUFFY, U.S.D.J.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

RICHARD D. BENNETT and CAROLE A. BENNETT, *Plaintiffs*,	:	84 Civ. 3038 (KTD)
v.	:	JUDGMENT
U. S. TRUST CO. OF NEW YORK, *Defendant*.	:	

Defendant(s) having moved for an order pursuant to Rule 12(b)(6) of the FRCP, and the said motion(s) having come before the Honorable KEVIN T. DUFFY, U.S.D.J., and the Court thereafter on NOVEMBER 27, 1984, having handed down its MEMORANDUM AND ORDER, DISMISSING THE COMPLAINT, IT IS,

ORDERED, ADJUDGED AND DECREED: That the complaint be and it is hereby dismissed.

DATED: NEW YORK, N.Y.
NOVEMBER 29, 1984

_____
Clerk

APPENDIX C
The Racketeer Influenced and Corrupt Organizations Act

18 U.S.C. §1962. Prohibited activities

. . .

(c) It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

Section 7 of the Securities Exchange Act of 1934, 15 U.S.C. §78(g)

Margin Requirements

Sec. 7. (a) For the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Board of Governors of the Federal Reserve System shall, prior to the effective date of this section and from time to time thereafter, prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security). For the initial extension of credit, such rules and regulations shall be based upon the following standard: An amount not greater than whichever is the higher of—

(1) 55 per centum of the current market price of the security, or

(2) 100 per centum of the lowest market price of the security during the preceding thirty-six calendar months, but not more than 75 per centum of the current market price.

Such rules and regulations may make appropriate provision with respect to the carrying of undermargined accounts for limited periods and under specified conditions; the withdrawal of funds or securities; the substitution or additional purchases of securities; the transfer of accounts from one lender to another; special or different margin requirements for delayed deliveries, short sales, arbitrage transactions, and securities to which paragraph (2) of this subsection does not apply, the bases and the methods to be used in calculating loans, and margins and market prices; and similar administrative adjustments and details. For the purposes of paragraph (2) of this subsection, until July 1, 1936, the lowest price at which a security has sold on or after July 1, 1933, shall be considered at the lowest price at which such security has sold during the preceding thirty-six calendar months.

(b) Notwithstanding the provisions of subsection (a) of this section, the Board of Governors of the Federal Reserve System may, from time to time, with respect to all or specified securities or transactions, or classes of securities, or classes of transactions, by such rules and regulations (1) prescribe such lower margin requirements for the initial extension or maintenance of credit as it deems necessary or appropriate for the accommodation of commerce and industry, having due regard to the general credit situation of the country, and (2) prescribe such higher margin requirements for the initial extension or maintenance of credit as it may deem necessary or appropriate to prevent the excessive use of credit to finance transactions in securities.

(c) It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer—

(1) on any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section;

(2) without collateral or on any collateral other than securities, except in accordance with such rules and regulations as the Board of Governors of the Federal Reserve System may prescribe (A) to permit under specified conditions and for a limited period any such member, broker or dealer to maintain a credit initially extended in conformity with the rules and regulations of the Board of Governors of the Federal Reserve System, and (B) to permit the extension or maintenance of credit in cases where the extension or maintenance of credit is not for the purpose of purchasing or carrying securities or of evading or circumventing the provisions of paragraph (1) of this subsection.

(d) It shall be unlawful for any person not subject to subsection (c) to extend or maintain credit or to arrange for the extension or maintenance of credit for the purpose of purchasing or carrying any security, in contravention of such rules and regulations as the Federal Reserve Board shall prescribe to prevent the excessive use of credit for the purchasing or carrying of or trading in securities in circumvention of the other provisions of this section. Such rules and regulations may impose upon all loans made for the purpose of purchasing or carrying securities limitations similar to those imposed upon members, brokers, or dealers by subsection (c) of this section and the rules and regulations thereunder. This subsection and the rules and regulations thereunder shall not apply (A) to a loan made by a person not in the ordinary course of his business, (B) to a loan on an exempted security, (C) to a loan to a dealer to aid in the financing of the distribution of securities to customers

not through the medium of a national securities exchange, (D) to a loan by a bank on a security other than an equity security, or (E) to such other loans as the Board of Governors of the Federal Reserve System shall, by such rules and regulations as it may deem necessary or appropriate in the public interest or for the protection of investors, exempt, either unconditionally or upon specified terms and conditions or for stated periods, from the operation of this subsection and the rules and regulations thereunder.

(e) The provisions of this section or the rules and regulations thereunder shall not apply on or before July 1, 1937, to any loan or extension of credit made prior to the enactment of this title or to the maintenance, renewal, or extension of any such loan or credit, except to the extent that the Board of Governors of the Federal Reserve System may by rules and regulations prescribe as necessary to prevent the circumvention of the provisions of this section or the rules and regulations thereunder by means of withdrawals of funds or securities, substitutions of securities, or additional purchases or by any other device.

(f)(1) It is unlawful for any United States person, or any foreign person controlled by a United States person or acting on behalf of or in conjunction with such person, to obtain, receive, or enjoy the beneficial use of a loan or other extension of credit from any lender (without regard to whether the lender's office or place of business is in a State or the transaction occurred in whole or in part within a State) for the purpose of (A) purchasing or carrying United States securities, or (B) purchasing or carrying within the United States of any other securities, if, under this section or rules and regulations prescribed thereunder, the loan or other credit transaction is prohibited or would be prohibited if it had

been made or the transaction had otherwise occurred in a lender's office or other place of business in a State.

(2) For the purposes of this subsection—.

(A) The term "United States person" includes a person which is organized or exists under the laws of any State or, in the case of a natural person, a citizen or resident of the United States; a domestic estate; or a trust in which one or more of the foregoing persons has a cumulative direct or indirect beneficial interest in excess of 50 per centum of the value of the trust.

(B) The term "United States security" means a security (other than an exempted security) issued by a person incorporated under the laws of any State, or whose principal place of business is within a State.

(C) The term "foreign person controlled by a United States person" includes any noncorporate entity in which United States persons directly or indirectly have more than a 50 per centum beneficial interest, and any corporation in which one or more United States persons, directly or indirectly, own stock possessing more than 50 per centum of the total combined voting power of all classes of stock entitled to vote, or more than 50 per centum of the total value of shares of all classes of stock.

(3) The Board of Governors of the Federal Reserve System may, in its discretion and with due regard for the purposes of this section, by rule or regulation exempt any class of United States persons or foreign persons controlled by a United States person from the application of this subsection.

Former Federal Reserve Regulation U, 12 C.F.R. §221.1(a)(1)(1983)*

[N]o bank shall extend any credit secured directly or indirectly by any margin stock for the purpose of purchasing or carrying any margin stock in an amount exceeding the maximum loan value of the collateral, as prescribed from time to time . . .

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78(j)(b)

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the the protection of investors.

Rule 10b-5 of the Securities Exchange Act, 17 C.F.R. §240.10b-5

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in

1. * Section 221.3(a)(1) of the present form of Regulation U is to the same effect. 12 C.F.R. §221.3(a)(1)(1984).

order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.